

Fiscal Note for SB 489

The Fiscal Note takes a narrow view on the possible impact to current income if the Board of Investments (BOI) is permitted to use this investment option for the trust funds.

BOI can use various investment options to minimize the current income reduction to the trust funds. These include:

1. Using investment vehicles that distribute both the dividend and realized capital gains. For example, most mutual funds usually distribute realized gains at least once a year. This would significantly increase the current income.
2. Use an equity strategy in the early years that would favor higher yielding stocks. For example, a portfolio of value stock would produce more current income. According to the Wall Street Journal, the dividend yield on the Dow Jones Large-Cap Value Index is 2.71% which is significantly higher than the Fiscal Note assumptions of 1.5-2.0%. The Dow Jones Select-Dividend Index has an even higher dividend of 3.42%.

| <u>Dow Jones Wilshire Index</u> | <u>Dividend yield</u> |
|---------------------------------|-----------------------|
| Large-Cap Growth Index | 0.86% |
| 5000 Composite Index | 1.66% |
| Large-Cap Value Index | 2.71% |
| Select-Dividend Tlt Index | 3.42% |

Source: Wall Street Journal 3/26/07, page C8

A portfolio that overweighs utility stocks would also increase the current yield. For example, the current dividend yield on the Dow Jones Utility Average is 2.9%.

3. BOI could consider diversifying into equity real estate. This asset class has a relatively high income component that is closer to the assumed bond yield.
4. BOI could harvest unrealized gains in the bond investments. As of 12/31/06, the unrealized gain in the Permanent Coal Trust account was over \$5 million.

Other Investment Considerations not address in the Fiscal Note

- Companies strive to reward shareholders over time by increasing the stock dividend. An increasing stock dividend will narrow the income difference between the equity dividend yield and bond yields. For example, if the initial dividend yield is 2.25% and if it grows 8% a year it would double in approximately 9 years. After 9 years the dividend yield would increase to 4.5% and after 18 years the dividend would increase to 9.0% based on cost. At the

same time, the coupon on a bond is not expected to increase over time since it is fixed for the life of the bond which could be up to 30 years.

- The Fiscal Note assumes a 6.5% equity appreciation per year. However, it doesn't assume any increase in the corpus which would also increase the income over time. Part of this capital appreciation will be distributed as realized gains and the unrealized gains component would increase the corpus and income.
- Long-term trust funds in other states are managed with significantly higher equity components than 25%. Two examples would be the Alaskan Permanent Trust and the Texas School Trust. The Alaskan fund also has a high income need since a large dividend is paid to citizens once a year.
- The 5.5% assumed yield for bonds in the Fiscal Note may be too optimistic since bonds yields have declined significantly since 1980s and the current yield on the 10-year U.S. Treasury Note is only 4.6%. The assumed total return on stocks may be too low since the average long-term return on large-cap stocks has been closer to 10%.
- BOI can take advantage of changing market conditions instead of selling bonds units and increasing equities. If interest rates decline and the income differential between bond yields and stock dividends narrow, equities can be increased with less impact on current income. If equity prices decline, BOI will have the option to take advantage of more favorable prices to increase the equity exposure. If bond prices increase, TFBP units can be sold at a gain which would increase income distribution.
- Allowing the BOI to use equities in the trust funds will increase the expected total rate of return and, at the same time, reduce the overall portfolio risk since stock and bonds prices don't move in the same direction. Adding equities would diversify the trust which is a very prudent action to take as a plan fiduciary.
- BOI could consider broadly diversifying the equity component that would further reduce portfolio risk and increase the expected total return. This would include mid and small-cap U.S. stocks, international stocks and private equity.
- Before investing in equities for any trust fund, BOI will have to develop a comprehensive asset allocation plan for each account that would take into consideration the current income needs along with the long-term benefits of diversifying into equities.

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